

STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 98-791

August 4, 1999

BANGOR HYDRO-ELECTRIC COMPANY
Request for Approval of Amendment and
Extension of Special Rate Contract with
Fort James

ORDER

WELCH, Chairman; NUGENT and DIAMOND, Commissioners

I. SUMMARY

By way of this Order, we approve an extension of the Special Rate Contract entered into between the Fort James Corporation (Fort James) and Bangor Hydro-Electric Company (BHE or Company). We find that Fort James (formerly James River Corporation)¹ could economically and physically self-generate and that BHE's decision to offer a discount to Ft. James is reasonable. We also find that although the termination provisions of the contract are asymmetric and that such asymmetry places certain risks on BHE and its ratepayers, these risks are outweighed by the potential benefits of Ft. James remaining a customer of BHE for an extended period of time and the risk that Ft. James will cease being a customer should we disturb the proposed agreement. Accordingly, we approve the extension of the special rate contract as filed.

II. PROCEDURAL HISTORY

See Appendix A.

III. FACTUAL BACKGROUND

In December 1993, BHE entered into a 20-year Power Sales Agreement (PSA) to supply electricity to Ft. James's paper mill in Old Town and other Ft. James facilities within the BHE service territory. The stated purpose of the PSA was to forestall the installation of a new cogeneration system and retain the Ft. James load by providing electricity priced below standard tariff rates but above BHE's short-term marginal costs.

As originally proposed, the PSA committed BHE to a 20-year contract, while permitting Ft. James to unilaterally terminate upon 24 months' prior written notice.²

¹In 1997, James River Corporation merged with Fort Howard Corporation (another paper products producer) to form Fort James Corporation (Fort James). For purposes of this document, we will refer to the customer as Ft. James.

²To the extent that BHE had committed to supply the PSA with electricity purchased under "Designated Contracts," the required notice period would be the greater of 24 months or the longest remaining term of the Designated Contracts.

Pursuant to concerns raised by Staff about the length of the proposed contract and the asymmetry of the termination provision, the PSA was amended in early 1994. Amendment No. 1 specified that: “[t]his Agreement shall terminate at 12:00 midnight on December 31, 1998 unless the Maine Public Utilities Commission shall have approved the continuation of this Agreement beyond that date.” Amendment No. 2 gave BHE the option to terminate the PSA unilaterally and immediately, if prior to March 1996, Ft. James gave notice of termination. On February 11, 1994, the Commission approved the PSA as amended by Amendments No. 1 and 2. *Bangor Hydro-Electric Company, Request for Review of James River Corporation Contract and for Accounting Order*, Docket No. 93-355 (Feb. 11, 1994).

On September 9, 1998, BHE and Ft. James entered into Amendment No. 3 to the PSA and filed it with the Commission for approval on October 13, 1998. Amendment No. 3 has four major provisions. First, it extends the contract term for 5 years (unless the PUC approves extension beyond that date). Second, as of the date of retail access, BHE no longer has any obligation to obtain power for Ft. James and the contract pricing is modified (\$250,000 per month and 3.5 mills per kWh, rather than \$250,000 per month plus 110% of marginal costs). Third, it revises the method for determination of marginal cost (prior to retail access). Finally, BHE agrees to undertake certain reliability improvements to its system to improve service to this customer.

IV. POSITIONS BEFORE THE COMMISSION

A. The Company

As part of its filing, the Company filed joint testimony of Carrol Lee and Lewis B. Elliot (Lee/Elliot). Lee/Elliot testified that the Company, as part of the renegotiation of the Ft. James contract, had retained the Bechtel Group to update its original assessment of Ft. James’s costs of self-generating. BHE expanded on Bechtel’s analysis and then compared the cost of cogeneration to the cost of power under the contract. Based on its analysis, BHE estimated that Ft. James would contribute approximately \$3 million per year towards BHE’s fixed costs under the special rate contract extension and it concluded that the special contract should be extended as proposed.

In the rebuttal testimony of Lee/Elliot, BHE argued that the Bench Analysis, Section IV (B), *infra.*, failed to account for the benefits provided by Ft. James beyond the next five years. BHE concedes that from a downside risk protection viewpoint, both the Company and its customers would be better off if Ft. James were willing to enter the contract with the addition of either of the amendments proposed by Staff. However, BHE posited that there is no guarantee that Ft. James would agree to

However, under the PSA and Amendment 1, Ft. James could still terminate upon 24 months notice if Ft. James relieved BHE of any remaining liability under the Designated Contracts.

such terms and if Ft. James were to walk away from the contract, then all of the potential contributions from Ft. James would likely be lost forever and not just for the remainder of the current contract. At oral argument, counsel for BHE referred to this as the “bird in the hand” analysis.

B. Bench Analysis

The Advisory Staff, by way of its Bench Analysis, provided the Commission with an extensive analysis of the proposed contract extension. The Staff posed the following questions as a framework for its analysis:

1. Is self-generation a viable alternative for Ft. James?
 - a. Would it be economic for Ft. James to install new cogeneration and cease taking service (other than standby service) from BHE absent the contract?
 - b. If it is economic for Ft. James to install new cogeneration, could a new cogeneration system physically be installed?
 - c. What are the potential impacts of natural gas availability on Ft. James’s self-generation alternative?
 - d. How does the advent of retail access affect the need to offer Ft. James a discount?
2. Is the Contract beneficial for BHE?
 - a. Is the discount offered by BHE appropriate in light of the cost of self-generation?
 - b. What are BHE’s costs to serve the proposed special rate contract?
 - c. Were BHE’s efforts to maximize revenue from Ft. James adequate?
 - d. Are BHE and its ratepayers adequately protected, given the asymmetry of the termination provision in the contract?

In response to the first threshold question, the Bench Analysis concluded that Ft. James could install self-generation at its Old Town mill and would likely do so absent a special rate contract. The Analysis noted that as part of the review of the original contract the Commission’s consultant examined the engineering information in BHE’s application, inspected the Old Town steam energy plant and prepared estimates of the cogeneration capital costs. These estimates concurred with Ft. James’s cost

estimates and indicated, at that time, that it would be economic for Ft. James to self-generate. The Bench Analysis concluded that no significant cost changes had occurred since that time which would alter the conclusions reached in the earlier Analysis. The advent of retail access is not likely to have a strong impact on Ft. James since under the existing (and proposed) special rate contracts, Ft. James can (and does) already have access to low cost electricity supplies from the wholesale markets via the "Designated Supply" contract provision.

In response to the second question, the Bench Analysis concluded that, assuming the capital costs projected by Ft. James and by Staff's consultants, BHE could not have offered a smaller discount to Ft. James and retained its load. Given the relative bargaining position of the parties, BHE did a reasonable job of maximizing revenue from this customer, but that BHE should consider taking steps to improve its bargaining position in the future.

The Bench Analysis did recommend, however, that the contract be amended to protect BHE from the possibility that Ft. James could exploit the benefits of the self-generation deferral rate and still proceed with the installation of self-generation. This possibility exists due to the asymmetric term provisions of the contract which allow Ft. James to terminate the contract on 24 months notice but bind BHE for the full 5-year term of the contract extension.

The Staff offered two contract provisions designed to protect BHE and its other customers from such an outcome for the first 2 years of the contract term. The first provision was an updated version of the existing Amendment No. 2 ("Amendment No. 2") and provides that if Ft. James gives its notice on or before December 31, 2000, BHE could (at its sole discretion) immediately terminate the agreement. Under the second provision ("taper provision"), if Ft. James gives its notice before December 31, 2000, it would pay the retail rate for purchases through December 31, 2000 and the contract rate for purchases through the remainder of the notice period. The taper provision would be a take-or-pay arrangement, based on a historic level of kilowatt-hour purchases, to prevent Ft. James from waiting to give its notice until it is prepared to self-generate, thereby avoiding all kilowatt-hour charges.

C. The OPA

The OPA argued that, in light of the impending restructuring of the electric industry, it might not be necessary to offer a special rate contract to Ft. James. Before customers such as Ft. James are given special rate contracts, they first should get their best deal in the competitive generation market. After generation supply has been secured BHE would then be in a position to consider the need to discount T&D service.

In the alternative, the OPA argued that in light of the contracts' asymmetric term provisions binding BHE to provide service for 5 years but allowing Ft. James to terminate by giving 24 months notice, at a minimum, the contract should be

amended as it was in 1994, to allow BHE to terminate the contract and charge Ft. James standard tariff rates if Ft. James provides notice of termination within the first 2 years. If this amendment is not required, the OPA suggested that the contract should only be approved for 2 years.

D. Ft. James

Ft. James argued that the reimposition of Amendment No. 2 would be punitive and contrary to the original contract, which they argued did not contemplate the renewal of Amendment No. 2 every five years. Ft. James indicated that at the time it entered into the original contract and agreed to the inclusion of Amendment No. 2, it believed that Amendment No. 2 was a one-time event. Ft. James also argued that it must have the flexibility allowed in the proposed contract extension to terminate the contract by providing 24 months notice in order to respond to opportunities as they arise in the competitive market.

At the oral argument, counsel for Ft. James argued that BHE's ratepayers are better off with the contract as proposed since Ft. James is providing an additional contribution to BHE's fixed costs with every additional minute that it remains on the system.

V. DECISION AND ANALYSIS

At the outset, we note that we do not believe it is necessary to delay considering this special rate contract until after the time that retail markets begin operation. Based on the economic data presented, it seems very doubtful that access to competitively priced generation alone would be sufficient to retain Ft. James's load. We note that Ft. James already has access to the competitively priced wholesale market under the current contract.

Based on the information presented, we find that the price provisions of the contract are reasonable given Ft. James's cogeneration options and the information available to Ft. James. While the asymmetric term provisions of the contract do pose some risk of lost revenues to BHE and its ratepayers, we believe that the risk of lost revenues would be even greater if we were to require the inclusion of Amendment 2 or the "taper provision."

As currently drafted, the special rate contract allows Ft. James to terminate the agreement with 2 years notice; power purchases during the 2-year notice period would be priced at the contract's discounted rate. Thus, Ft. James could receive discounted power under the proposed contract while installing its new cogeneration system. Absent the special contract, Ft. James would have bought power at standard tariff rates (which are much higher than the contract's discounted rates) while it completed the installation of new cogeneration. If the contract does not cause Ft. James to defer its self-generation option but merely allows Ft. James to buy discounted electricity

during construction of its self-generation, BHE and its ratepayers could be harmed by the contract.

We agree with BHE, however, that this risk cannot be viewed in isolation. First, we must look at the risk that Ft. James will walk away from the table should we require the inclusion of Amendment No. 2 or the "taper provision." If this were to occur then BHE and BHE's ratepayers would lose the potential contribution to fixed costs that Ft. James might provide over an extended period of time. Based on the representations made by Ft. James during this proceeding and by the passage of time since the filing of the contract extension, we believe it is unlikely that Ft. James will exercise its termination option within the first 2 years of the contract.

Therefore, we find, based on the increased likelihood that Ft. James will remain a long-term customer of BHE, that the potential benefits provided by Ft. James should it remain on the system outweigh the risks posed by the lost revenue should Ft. James exercise its termination option within the first 2 years of the contract.

Accordingly, we

O R D E R

That Amendment No. 3 to the BHE/Ft. James special rate contract is approved as filed by BHE on October 13, 1998.

Dated at Augusta, Maine, this 4th day of August, 1999.

BY ORDER OF THE COMMISSION

Dennis L. Keschl
Administrative Director

COMMISSIONERS VOTING FOR: Welch
 Nugent
 Diamond

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of review or appeal of PUC decisions at the conclusion of an adjudicatory proceeding are as follows:

3. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R.110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which reconsideration is sought.
3. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within 30 days of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Civil Procedure, Rule 73, et seq.
3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.

APPENDIX A

On October 9, 1998, Bangor Hydro-Electric Company ("BHE" or "Company") filed a petition requesting that the Commission approve an extension and amendment of the special rate contract with Fort James Operating Company (formerly the James River Company). The Commission approved the original contract in *Bangor Hydro-Electric Company, Request for Review of James River Corporation Contract and For Accounting Order*, Docket No. 93-355. That contract was due to expire at 12:00 midnight, December 31, 1998, unless the Commission approved the continuation of the agreement beyond that date. A Notice of Proceedings, which provided interested persons an opportunity to intervene in this matter, was issued on December 11, 1998. Petitions to intervene were filed by The Office of the Public Advocate (OPA) and by the Ft. James Corporations and were granted without objection.

Due to an administrative oversight, the Staff assigned to this case did not receive a copy of the Company's filing until early December, 1998. Given the impending expiration date, the Staff proposed that the then current contract be extended on a continuing month-to-month basis until the Commission took final action on the Company's petition. No party objected to the temporary extension proposal and on December 29, 1998, the Commission issued an Order Approving Limited Extension, allowing the contract between BHE and Ft. James to go into effect on January 1, 1999 on a month-to-month basis until the Commission took final action on this matter.

In support of its request for an extension of the contract, BHE filed the joint direct testimony of Carrol Lee, Vice President and Chief Operating Officer, and Lewis Elliot, Key Account Engineer (Lee/Elliot). After conducting both formal and informal discovery and attempting to resolve the case informally through a negotiated agreement, intervenor comments were filed by the OPA and Ft. James on April 6, 1999, and April 27, 1999, respectively. On May 4, 1999, the Advisory Staff, in conjunction with its consultant, the Goodman Group, filed its Bench Analysis in this matter, and on May 25, 1999, BHE filed the rebuttal testimony of Lee/Elliot.

By way of a Procedural Order dated May 3, 1999, a hearing on this matter was scheduled for June 15, 1999. Since all parties to the case waived cross-examination, the scheduled hearing was held solely to hear oral arguments of the parties. Oral argument was presented at that time by James Cohen, Esq., on behalf of BHE, and Anthony Buxton, Esq., on behalf of Ft. James.